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July 24, 1995

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William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 87-313 - Policy and Rules Concerning Rates for Dominant Carriers;*
CC Docket No. 93-197 / Revisions to Price Cap Rules for AT&T

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their *"Reply Comments"* in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Enclosure

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Policy and Rules Concerning Rates for Dominant Carriers Revisions to Price Cap Rules for AT&T	CC Docket Nos. 87-313, 93-197

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REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

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SUMMARY

In its Comments, AT&T complains that the proposed new rules would hinder its ability to "respond effectively to competition in the rivalrous interexchange marketplace." Translated, this means that they would somewhat constrain AT&T's abilility to raise prices to the majority of its residential customers.

Raising prices to most of one's customers is an unusual way to respond to "rivalrous" competition. But that is what AT&T and its putative competitors have been able to do for several years. AT&T never explains how lockstep price increases could occur in a "rivalrous" marketplace characterized by rapidly decreasing costs. In fact, such price increases are a classic symptom of market power.

The Commission has concluded that basic MTS and alternative pricing plans ("APPs") are "like" services. Eligible customers choose between them based solely on price. Judicial precedent requires the Commission to examine the costs of like services and articulate with precision the justification for any differences in price. No such justification offers itself for APPs. AT&T says only that "the averge cost of serving 'low volume' customers is significantly higher than the average cost of serving 'high volume' customers." There are at least three things wrong with this assertion.

First, AT&T defines "low volume" as "under $3 a month", which does not correspond to the customer base for basic MTS. All evidence suggests that basic MTS is already a highly profitable service.

Second, AT&T has not said what the cost of providing any service to any customer or even customer segment is. AT&T complains that to do so would be "burdensome."

Whether or not this is the case, its refusal deprives the Commission of the only evidence that would justify the price discrimination between basic and discounted MTS.

Third, when it refers to the "*average cost*" of serving "low volume" customers, AT&T appears to argue that MTS price increases are needed to recover some form of fully distributed cost that allocates fixed costs and overheads to customers (albeit with the allocations undisclosed). This is wrong, both as a matter of economics and a matter of law, and contradicts AT&T's claim to be a competitive enterprise. As an economic principle, competitive enterprises are content to recover the *incremental cost of a service*. As AT&T's consultant Prof. Willing indicates, they set prices for individual customers or customer segments based on marginal costs and elasticities, not by allocating non-assignable costs. As a legal principle, not since rate of return regulation has there been any presumption that carriers should be entitled to recover their "average costs" from every customer. AT&T has never availed itself of the option of filing an above-band price increase for "low volume" customers supported by an average variable cost (AVC) showing. We suspect the reason is that the incremental costs of providing MTS service to basic and discount customers are the same, and that there are few, if any, MTS customers from whom AT&T does not recover its marginal cost. More evidence would be needed to justify the Commission's (let alone AT&T's) proposal to let basic MTS rates continue to increase.

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

Policy and Rules Concerning Rates for Dominant Carriers Revisions to Price Cap Rules for AT&T	CC Docket Nos. 87-313, 93-197

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell (the "Pacific Companies") hereby respectfully reply to the Comments of AT&T Corp. ("AT&T") in the above-captioned proceeding.

AT&T calls the proposed rules "a step backwards" because they "would inappropriately fetter AT&T's ability to respond effectively to competition in the rivalrous interexchange marketplace." (AT&T, pp. 3, 5.) But AT&T's own actions suggest the interexchange marketplace is far from "rivalrous":

- AT&T vigorously opposes new facilities-based entrants to the interexchange marketplace.
- AT&T vigorously opposes any constraints on its ability to increase prices. AT&T supports the removal of price caps from all services. In the alternative, AT&T supports the *inclusion* of promotions and optional calling plans (collectively alternative pricing plans, or "APPs") in price cap regulation, provided that the flexibility this creates to increase basic MTS prices is unconstrained.
- AT&T has raised basic MTS rates for several years running. Whether these rate increases are offset by APPs, we cannot say. Contrary to the Commission's rules, AT&T does not file supporting materials "sufficient to establish compliance with the applicable bands, and to

calculate the necessary adjustment to the affected APIs and SBIs,"[1] or other supporting materials required by the rules.[2]

- On August 1, 1995, AT&T's access costs will fall by about $680M annually. None of AT&T's rates, however, will be reduced.

For reasons we stated in our Comments, we support deregulation of competitive markets. The long-distance business is not fully competitive. Until other facilities-based carriers (such as the BOCs) are allowed to compete, the proposed rules may be inadequate to prevent further, anticompetitive MTS price increases and the resulting likely erosion of universal service. But the proposed rules are better than nothing. And what AT&T advocates (reclassification as a nondominant carrier) is just that -- nothing.

In competitive markets, prices do not ordinarily rise when costs are falling. AT&T's suggestion that basic MTS prices have increased because the market is *more* competitive than it used to be, proving that prices should be allowed to increase some more, is an astonishing chain of illogic. It is also unsupported.

I. AT&T's Market Power

Referring to the issues currently being considered in CC Docket No. 79-252, AT&T says, "AT&T no longer has any market power in the interexchange market. Any attempt by AT&T to engage in supracompetitive pricing would necessarily fail, because it would result in a substantial loss of customers to competitors. In the two years since AT&T filed its reclassification motion, competition has intensified to new levels, which has made price cap regulation even more

[1] 47 CFR section 61.49(b). See letter from John W. Bogy, Senior Counsel, Pacific Bell to William F. Caton, Acting Secretary, FCC, July 7, 1995. AT&T also does not file information to support its "estimate" of the required access charge reductions (the "Delta Y"). See Bell Atlantic Petition to Deny (AT&T 1995 Price Cap Filing), July 7, 1995.

[2] See 47 CFR Sections 61.44(b), 61.46(a), 61.47(a), 61.49(a).

burdensome and obsolete." (AT&T, pp. 6-7.) To support this contention AT&T makes four points. None of them is persuasive. We respond briefly to each one below.

1. "It is well established that AT&T's competitors have enormous excess capacity and could absorb a substantial portion of AT&T's traffic in a short amount of time.... This excess capacity creates an inherently unstable situation that effectively precludes the possibility of any oligopolistic collusion." (AT&T, pp. 8-9.) Excess capacity can indicate the absence of market power. But in practice, as Prof. MacAvoy shows in his Affidavit (appended as Exhibit A), it has done nothing to upset the oligopolistic structure of the long distance market.

AT&T complains that the proposed rules impose "additional regulatory burdens that uniquely disadvantage AT&T." (AT&T, p. 25.) This glosses over a central hypocrisy in AT&T's position. AT&T's opposition to "additional regulatory burdens" is strictly conditional. AT&T itself does not seek the removal of APPs from price cap regulation unless *all* services are removed from price cap regulation. AT&T's concern is maximizing its ability to increase revenues, not avoiding regulation.

2. "Basket 1 customers are well aware of their choices in the interexchange market, and are ready and willing to switch carriers whenever it suits their needs. The most dramatic illustration of this is the rate of customer 'churn' in recent years, which has been increasing rapidly." (AT&T, p. 9.) Neither churn among residential customers, nor the ad campaigns that prompt it, prove that the interexchange market is competitive. Firms that are not competing on price often shift their efforts to attracting customers through advertising and "lump sum rewards" (AT&T, p. 10). Once the lump sum reward is spent, the customer, now paying the same old supracompetitive prices, has every incentive to switch carriers again. "Churn" is just as much evidence of consumer frustration as it is evidence of competition. Thus, it is not generally considered by economists or antitrust courts to be relevant to market power.

3. "The steep decline in prices that has occurred in the interexchange market since divestiture is another strong indicator of competition. ***AT&T's average revenue per minute ("ARPM") declined by 63 percent between 1983 and 1992." (AT&T, p. 11.)*** ARPM fails to prove anything about competition because it measures neither prices nor profits -- nothing that directly indicates the level of competition in a market. Thus, ARPM can decrease even as prices and/or profits are increasing. A reduction in cost does not affect ARPM at all. AT&T's recent decision to reduce no consumer prices after a $680M reduction in access costs[3] did not change its ARPM, for example, but it did substantially increase AT&T's profit margins on all services that include access costs.[4]

AT&T says that the reason that ARPM has declined "is that customers continue to migrate to the lower priced services that competitive market forces have made available to them." (AT&T, p. 11.) Indeed, AT&T claims that "total savings ... exceed $1 billion annually." (AT&T, p. 33.) But $1 billion less than *what?* These "savings" are merely discounts from AT&T's basic MTS rates, which under current price cap rules may be increased to offset the discounts, with no overall

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3 See "AT&T to Pass $350 Million in Savings on to Consumers," *Wall Street Journal*, May 19, 1995, at B4; Mike Mills, "Critics Doubt AT&T Plan to Pass on Lower Rates," *Washington Post*, May 19, 1995, at F3; letter from M. F. Del Casino, Administrator - Rates and Tariffs, AT&T, to William F. Caton, Acting Secretary, Federal Communications Commission, June 22, 1995. AT&T plans only to "extend" its TrueUSA plan. This discount will expire after a few months, which would mean a revenue increase for AT&T as well as a permanent access cost decrease.

4 See our Comments, Exhibit A (Taylor and Zona).

reduction in consumer prices. Indeed, to the degree that AT&T can reduce its APIs and SBIs by projections of discounts it offers on *intrastate* calling, overall consumer prices may even increase.[5]

Actions speak louder than ARPMs. AT&T's costs recently fell by $680M, but its prices remained the same. Now AT&T seeks *relief* from the requirement that revenue increases from basic MTS be *limited* to the amount of lost revenue from discounts, relief that would allow its overall revenues to increase. These actions are impossible to reconcile with "rivalrous" competition.

4. "Basket 1 customers have a broad array of choices from numerous competing IXCs.... AT&T's competitors have become increasingly strong companies and have substantially diminished AT&T's share of the interexchange market." (AT&T, pp. 11-12.) More than a decade after divestiture, AT&T, MCI, and Sprint are still the only national, facilities-based carriers, accounting for 97 percent of all interexchange fiber placement.[6] As Prof. MacAvoy shows, after 1989 the market concentration of AT&T, MCI, and Sprint stabilized[7] -- and MTS rates began to rise.

AT&T complains of "the Commission's unsupported and incorrect assumption that AT&T may have the ability to exercise market power in Basket 1 services" (AT&T, p. 16). But the ability to raise prices while costs are falling, without losing customers, is classic evidence of market

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5 See letter from R. Gerard Salemme, Vice President - Government Affairs, AT&T, to Kathleen Wallman, Chief, Common Carrier Bureau, FCC, May 11, 1995. For examples of such "wraparound discount" filings, see AT&T Transmittal Nos. 8155 (February 10, 1995), 8155-A (February 13, 1995), 8156 (February 10, 1995), and 8278 (March 10, 1995).

6 Jonathan M. Kraushaar, FCC, Industry Analysis Division, *Fiber Deployment Update, EOY 1993*, Table 2 (May 1994).

7 See Affidavit of Paul W. MacAvoy, United States v. Western Electric Co., Civ. No. 82-0192 (Dist. Ct. D.C.), appended hereto as Exhibit A.

power. It fully explains why AT&T opposes new entrants and seeks more flexibility to increase prices. It cannot be wished away.

II. AT&T's Discriminatory Prices

As the Commission noted (FNPRM, para 38), basic MTS and APPs are "like" services. Customers view them as equivalent except for price. AT&T's prices for them are discriminatory. Yet, as we pointed out in our Comments, AT&T has never shown that its discriminatory price structure for these services is justified by any difference in cost. Such a cost showing is what the Communications Act requires to justify price differences between "like" services. If the cost is the same, the Commission "must articulate with precision its reasons for tolerating any discrepancies it uncovers" in the prices.[8]

AT&T has offered up factoids, anecdata, unsupported assertions -- anything but evidence of *the difference in cost between discounted and undiscounted MTS services.* AT&T says that "the average cost of serving 'low volume' customers is significantly higher than the average cost of serving 'high volume' customers." (AT&T, p. 32.) But AT&T defines "low-volume" customer as "under $3 a month," which is not the only customers whose rates it seeks flexibility to increase. AT&T never denies that it makes a healthy profit already from the *majority* of its customers who make less than $10 a month in calls and, hence, do not benefit from APPs. Or, in AT&T's words, customers whose "preferences for making relatively few calls will render them ineligible" for discounts. (AT&T, p. 36, n.66.)

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[8] *MCI Telecommunications Corp. v. FCC,* 842 F.2d 1296, 1307 (D.C. Cir. 1988). See also 842 F.2d at 1303, and *Ad Hoc Telecommunications Users Com. v. FCC*, 680 F.2d 790, 796, n.13, 797 (D.C. Cir. 1982).

AT&T wants to have it both ways. AT&T refers to cases holding that a discriminatory rate structure "is not unlawful if it is justified by the cost of the respective services" (AT&T, p. 34, n.62), but AT&T refuses to say what *any* customer's or service's cost is. (See AT&T, p. 37, n.67.) AT&T complains that to do so would be "burdensome." (AT&T, p. 35.) The "burdensome" exception is not found in any cases. It is found only in AT&T's Comments. Moreover, it is difficult for us to believe that it would be "burdensome" for AT&T to disclose its incremental costs for discounted and undiscounted MTS. Not only must AT&T know what its incremental cost is to be making profitable business decisions, but it is required to file incremental cost data for new services it proposes to offer in California.[9]

AT&T's costs, though, are widely known to a fair degree of accuracy. And all evidence suggests that AT&T's incremental costs are not different for different MTS customers. When AT&T applied to the CPUC for permission to offer various volume discounts in California, it testified that its network costs were "approximately $0.01 per minute of use."[10] From such evidence, it is safe to conclude that the network cost of serving "low volume" customers will not break AT&T, the most profitable of the Fortune 500, anytime soon. The other two major costs of providing toll services that AT&T has identified are usage-sensitive, so that, if they pay the same usage prices, "low volume" and "high volume" customers contribute to them in cost-causative proportions. These are access costs and billing costs.[11] If an AT&T customer that we bill makes no calls, as AT&T complains 10 million of its customers fail to do each month (AT&T, p. 37, n.67), to

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[9] See *Re AT&T*, D.90-11-029, 38 Cal. P.U.C. 2d 126, Ordering Para. 1 (1990).

[10] Initial Brief of AT&T Communications of California, Inc. (U 5002 C), A.88-07-020, A.88-08-051, and A.89-03-046, filed June 18, 1990, p. 45.

[11] See our Comments, pp. 11-12.

the best of our knowledge AT&T incurs no marginal network costs, access costs, or billing costs for that customer.

If there is any truth to AT&T's claim that "basic schedule rates do not even cover AT&T's costs" (AT&T, p. 37), it is only because AT&T means *average* costs. (See AT&T, p. 32.) Here again -- and we remind the Commission that AT&T has offered no evidence of average cost, incremental cost, or any other cost, of any customer -- AT&T wants to have it both ways. AT&T wants to be treated as a competitive enterprise, contending that the long distance market enjoys "rivalrous competition." Competitive firms will offer a service if they expect to recover the *incremental cost of the service*. But like a monopolist, AT&T complains that "the *average cost* of serving 'low volume' customers is significantly higher than the *average cost* of serving 'high volume' customers." (AT&T, p. 32; emphasis added.) The difference between incremental cost and average cost (*e.g.,* fixed costs and overheads) is by definition not caused by any particular customer for a service. Since "high volume" and "low volume" MTS customers are customers of the same service (MTS), AT&T's statement is either untrue, or AT&T is using a form of fully allocated cost that would be wholly irrelevant to the decisions of a competitive enterprise. AT&T's unexplained and apparently self-serving references to its "costs" underscore the need for the Commission to examine the respective costs of basic and discounted MTS service.

In any event, the requirement for AT&T to recover a contribution to average costs from every customer went out with rate of return regulation. Under price caps, it is no longer to be expected that all customers will contribute equally to the difference between marginal costs and average costs. The specific aim of price caps is to allow "second best" pricing, in which some services recover their incremental costs and no more, just as they do in competitive markets.[12]

AT&T also argues that price discrimination between basic MTS and discounts is reasonable because "discounted rates are reasonably accessible to all customers." (AT&T, p. 36.) It cites cases holding, for example, that discrimination is not unreasonable when "customer choice, rather than a carrier-imposed barrier, controls the availability of the discounted rate." (AT&T, p. 36, n.65.) We agree with AT&T that discounting can increase consumer welfare. But AT&T has made no serious attempt to justify these particular discounts, and it has misconstrued the legal standard in thecases it cites. In essence, AT&T says that if a customer does not make enough calls to qualify for the discount, the customer has not been unjustly discriminated against, because he could have made more calls. Almost any "carrier-imposed barrier" would be reasonable judged against such a standard, provided the customer could have overcome the barrier by making different (even irrational) purchasing decisions. It does not inquire whether the discount is justified by cost or competitive criteria. It would allow the very act of discrimination to justify itself. It is AT&T, after all, who determines the customer's purchasing decisions by setting the discriminatory price points in the first place.

As even AT&T seems to concede (AT&T, p. 34), the Communications Act requires a showing that discriminatory prices for like services are justified by differences in costs and competitive conditions. AT&T consciously has declined to make such a showing. None of AT&T's costs for any service or customer are ever disclosed. Why AT&T's prices and profits should rise as competition supposedly increases is never convincingly explained.

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[12] See *National Rural Telecom Ass'n v. FCC*, 988 F.2d 175, 182 (D.C. Cir. 1993).

There are strong economic arguments for certain types of discounts. Prof. Willig articulates this point well in his Attachment to AT&T's Comments. But in AT&T's case it is not very probative. To his credit, Prof. Willig neither asserts that AT&T's basic MTS rates must be raised to recover their costs, nor contends that "average costs" are the economically relevant costs to recover, nor says there is any difference in cost between serving basic and discounted MTS customers.

III. MTS Prices and Universal Service

The Commission asked whether increases in basic MTS rates affect the availability of local telephone service (FNPRM, para. 61). For reasons we stated in our Comments, when price increases in basic MTS coincide with a statistically significant decline in telephone penetration, it strongly suggests that a correlation may exist.

AT&T makes two obvious misstatements about this. First, it selectively reads and therefore misrepresents the Commission's own data, saying, "although the November 1994 [telephone] penetration level declined by 0.4 percent from the percentage of households with telephones a year earlier, the Commission's study concludes '[t]his decline is not statistically significant.'" (AT&T, p. 31, n.56, citing "Telephone Subscribership in the United States," Industry Analysis Division, Common Carrier Bureau, April 1995, Table 1.) But the more recent Monitoring Report in CC Docket No. 87-339 adds, "The annual average penetration rate for 1994 was also 93.8%, which is down 0.4% from the 1993 annual average penetration rate. *This decline is statistically significant.*"[13] For reasons that Report explains, the annual average penetration rate has

[13] "Monitoring Report, CC Docket No. 87-339, May 1995," Federal and State Staff for the Federal-State Joint Board in CC Docket No. 80-286, p. 13 (emphasis added).

a higher confidence level than the rate of household subscribership.[14] AT&T omitted the more reliable statistic, apprently because it was harder for it to accept.

Second, AT&T says of studies including the Field Research Corp. (FRC) study (conducted for Pacific Bell and GTE at the direction of the CPUC), "these same studies suggest that subscription to premium local services (e.g., call waiting, call answer, and unpublished numbers) is strongly correlated with disconnection of local service for nonpayment." (AT&T, p. 30; emphasis in original.) There is no such "strong correlation" in the FRC study. The only finding remotely relevant to this claim relates to *customers,* not non-customers. It says, "Those who have any of the Custom Calling Services (CCS) do not find telephone service as affordable as those who do not have any CCS services (59% "very easy" vs. 64%). The CCS customers also report a higher incidence of having problems paying their telephone bill."[15] The correlation suggested in the study is thus between customers' perceived ease of payment of their bill and their subscription to CCS. The percent figures reported have a range of error of plus or minus 3%,[16] which makes the correlation potentially statistically insignificant. Moreover, no correlation is suggested between subscription to CCS and disconnection of service.

IV. Conclusion

Until new facilities-based carriers bring competition to the long distance market, the proposed rules would be inadequate to protect against discriminatory price increases for the majority of long distance customers. In the meantime we urge the Commission to reaffirm its

[14] *Id.*

[15] Field Research Corporation, "Affordability of Telephone Service", Vol. 2 (Customer Survey), Table 4.7A.

[16] *Id.* at A-26.

previous policy of limiting AT&T's flexibility to increase basic MTS rates. Since the current "residential index" has not effectively limited basic MTS price increases, we also support the proposal to replace it with a "basic rate index" (BRI) that would not include discounts or promotions. There should be no upward pricing flexibility in the BRI.

Respectfully submitted,

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Their Attorneys

Date: July 24, 1995

EXHIBIT A

IN THE
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA,	)	
Plaintiff,	)	
v.	)	Civ. No. 82-0192 (HHG)
WESTERN ELECTRIC COMPANY, INC., AND AMERICAN TELEPHONE AND TELEGRAPH COMPANY,	)	
Defendants.	)	

AFFIDAVIT OF PAUL W. MACAVOY

1. My name is Paul W. MacAvoy and I hold the Williams Brothers Professorship in Management Studies at the Yale School of Management. Currently I am also Dean of the School, and formerly I was Dean and Olin Professor at the University of Rochester's William E. Simon Graduate School of Business Administration. At the Massachusetts Institute of Technology in the 1970s I was the Henry R. Luce Professor of Public Policy. At Yale in the early 1980s I was the Steinbach Professor of Organization and Management and later the Beinecke Professor of Economics. My M.A. and Ph.D. degrees in economics are from Yale University, and my A.B. degree as well as an honorary doctorate come from Bates College. In 1981, I was elected to the American Academy of Arts and Sciences.

2. My professional work has centered on regulation and strategic decision making by firms in the energy, transportation, and communications industries. I have authored numerous journal articles and sixteen books, including most recently *Industry Regulation and the Performance of the American Economy* (W.W. Norton 1992). I have served on the editorial

boards of several journals and was the founding editor of the *Bell Journal of Economics and Management Science*. My writings on regulation have been referenced by the Supreme Court of the United States in four separate cases, and by lower federal courts in more than twenty cases.

3. A considerable part of my career has been devoted to public service. In 1965-66, I served as staff economist on the Council of Economic Advisers and in 1966 was a member of President Johnson's Task Force on the Antitrust Laws. During the Ford administration, I was a member of the President's Council of Economic Advisers and co-chairman of the President's Task Force on Regulatory Reform. President Carter appointed me to the Council of the Administrative Conference of the United States, and President Reagan appointed me to the National Productivity Advisory Committee. My work in Washington has also included fellowships at both the Brookings Institution and the American Enterprise Institute.

4. In addition to these policy-related activities, I have served as a member of the board of directors for several corporations, including currently Alumax Corporation, American Cyanamid Company, the Chase Manhattan Bank Corporation, and LaFarge Corporation. My previous directorships have included Colt Industries, Inc., Combustion Engineering, Inc., Columbia Gas, and the United States Synthetic Fuels Corporation. I have consulted and testified in numerous antitrust and regulatory proceedings. From 1978 to 1982, I assisted the American Telephone and Telegraph Company in framing its antitrust defense strategy in the government's divestiture case, which produced the Modification of Final Judgment (MFJ).

SUMMARY OF FINDINGS

5. This affidavit provides a detailed assessment of the extent of competition in various markets for interLATA services. My principal findings are as follows:

- Both business and other interexchange markets have been highly concentrated at oligopoly levels since the 1984 divestiture. While concentration fell in the late 1980s, it stabilized in the 1990-93 period. The newly gained stability in shares has made it possible for AT&T, MCI, and Sprint to set their prices simultaneously at noncompetitive levels, *as if* in "tacit collusion."

- A number of important conditions in these markets have been highly conducive to tacit collusion in price setting, but not to the development of other more competitive forms of interfirm behavior.

- Tacit collusion in pricing interLATA services was supported by the tariffing process of the Federal Communications Commission (FCC or Commission) even when the Commission tried to make pricing more competitive.

- The price-cost margins for interLATA services after 1990 have increased while concentration has stabilized in various markets. Rather than markets becoming more competitive as firms shares of sales became more equal, these markets have become more tacitly collusive in pricing. Differences in price-cost margins across markets have followed a systematic pattern consistent only with tacit collusion.

6. These findings conclusively show that AT&T, MCI, and Sprint have not set prices for interLATA services competitively. To the contrary, these three firms have developed market sharing and identical pricing patterns to an extent that results in a classic case study in tacit collusion. Eliminating the MFJ's interLATA restriction and permitting the Regional Bell Operating Companies (RBOCs) to compete against the current pricing arrangement of the interexchange carriers could only move markets toward competition and increase consumer welfare.

I. INTRODUCTION

7. The extent of competition in long-distance telecommunications determines the soundness of arguments for continuing line-of-business restrictions on the entry of the Regional Bell Operating Companies (RBOCs) into these services. This affidavit provides an assessment of the performance of existing large carriers to determine whether sufficient "competition" now prevails based on tests for "competition" in economic analysis. My tests for price behavior over the last decade establish that AT&T, MCI, and Sprint have not competed in various long-distance service markets and that the pattern of prices across these service markets has been systematically noncompetitive. To remedy this condition, the RBOCs should be allowed to use capacity already in place to offer competitive services; thus the artificial barrier created by the MFJ that blocks them from offering interLATA services should be eliminated. I have advocated for the past ten years that the RBOCs should be allowed to provide interLATA services,[1] and my further analyses based on new evidence reported in this affidavit confirms and strengthens my earlier policy prescription.

8. Some previous studies have concluded, to the contrary, that competition now prevails in the provision of long-distance services. These are flawed because they have relied too extensively on structural indicators of concentration and have not examined how pricing in actual service has in fact taken place. In its report on *Competition in the Interstate Interexchange Marketplace*, August 1, 1991, the Federal Communication Commission found that competition was extensive enough to justify removing much of its price regulation of AT&T's services.[2] The Commission gathered evidence on market shares and the supply capacities of the carriers, as well as the demand elasticities of the customers, in specific long-distance markets. In reviewing this

[1] Paul W. MacAvoy & Kenneth Robinson, *Winning by Losing: The AT&T Settlement and Its Impact on Telecommunications*, 1 YALE J. ON REG. 1 (1983) [hereinafter *Winning by Losing*]; Paul W. MacAvoy & Kenneth Robinson, *Losing By Judicial Policymaking: The First Year of the AT&T Divestiture*, 2 YALE J. ON REG. 225 (1985) [hereinafter *Losing by Judicial Policymaking*].

[2] Competition in the Interstate Interexchange Marketplace, 6 F.C.C. Rcd. 5880 (1991).

evidence, it concluded: "[W]e believe and the record confirms that competition in business services is thriving, that AT&T's competitors are growing, and that consumers are benefiting from these occurrences."[3] Based on this finding, the Commission removed AT&T's business services from price-cap regulation, effective as of November 1991.[4] Two years later, the Commission also evaluated its evidence on concentration in the supply of 800 services and concluded that this market was sufficiently competitive to remove AT&T from price-cap regulation effective May 1993.[5] The FCC's position relied most heavily on changes in market structure for determining that competition would protect consumers from monopoly or oligopoly pricing.[6]

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[3] *Id.* at 5892.

[4] *Id.* at 5911.

[5] Competition in the Interstate Interexchange Marketplace, 8 F.C.C. Rcd 3668 (1993).

[6] The FCC supplemented its structural analysis with the finding that "AT&T's pricing of business services since the implementation of price cap regulation lends additional support to our conclusion." *Id.* at 5889. But that support is faulty. The FCC's position was that since actual prices were systematically below the allowed "caps" or ceilings, markets must be competitively pricing. But these caps, based on adjustments over time to productivity changes, would not approximate to prices set in competitive markets. This is because regulated prices are always higher than either competitive or non-competitive market prices. *See* Paul W. MacAvoy, *Prices After Deregulation*, 1 HUME PAPERS ON PUBLIC POLICY, 42 (1994).

9. In applied economics, measures of concentration have been found to be inadequate for determining the competitiveness of markets.[7] To be sure, factual analysis of specific markets has

[7] The following quotations are representative of the position that concentration measures are insufficient for formulating conclusions on market competitiveness:

> Concentration indices are at best only a rough one-dimensional indicator of monopoly power, and their use must be tempered with common sense.

FREDERICK M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 79 (Houghton Mifflin Co., 3d ed. 1990).

> An increasingly influential viewpoint seems to be that differences among industries are so complex that simple generalizations (for example, few sellers lead to high profit rates) are invalid. What is advocated is to study industries on a case-by-case basis, applying and adapting economic models as appropriate to the industry in question.

W. VISCUSSI, J. VERNON & J. HARRINGTON, ECONOMICS OF REGULATION AND ANTITRUST 54 (D.C. Heath & Co. 1992).

> [T]raditional concentration measures are good predictors of market power and the efficiency of the industry equilibrium. However, as will be shown in the following sections, the predictive power of these measures depends crucially on whether products are homogeneous or differentiated, whether entry barriers exist, and whether firms compete with prices or quantities.

DANIEL F. SPULBER, REGULATION AND MARKETS 504-05 (MIT Press 1989).

> [W]hile it seems likely that increased concentration matters, other things equal, we are very far from having a decent specification of just what the other things are and how to measure them. A policy that uses concentration levels in different industries should be based on a theory that takes into account the many other phenomena that make industries differ in terms of the likelihood of tacit collusion.

FRANKLIN M. FISHER, INDUSTRIAL ORGANIZATION, ECONOMICS, AND THE LAW 202-03 (MIT Press 1991).

> In a variety of situations, market share and market concentration data may either understate or overstate the likely future competitive significance of a firm or firms in the market.

found that low concentration, such as four-firm shares of sales below 30 percent, can be associated with competitive price and output behavior.[8] However, studies of market performance have certainly not established that markets are always competitive where concentration is high. Indeed, no other study has presumed that markets would be competitive with three firms providing almost all of the sales, and where the largest firm has twice the market share of the second firm. Such highly concentrated markets have exhibited both noncompetitive and competitive patterns of pricing and sales behavior depending on other conditions in those markets. With only three major suppliers, limited reductions in high concentration levels are insufficient to indicate that competition exists in operating and strategic behavior.

10. Competition is a dynamic process in which firms in a market systematically strive to improve their positions relative to their rivals. That process drives firm prices towards marginal costs, reducing the firm's price-cost or operating income margins towards levels just sufficient to support replacement of plant and equipment. Of course, unexpected changes in demand and technology prevent the price level from ever reaching marginal costs, and thereby ever eliminating (excess or higher) profit margins. But competitive behavior is realized in *falling* profit margins, as the number of firms increases, and in *reduced* margins, as the number becomes sufficient to establish the competitive process. As leading firms with advanced technologies use their cost advantages to undercut rivals' prices, both prices and margins should decline. Even so, relatively high rates of growth of a second or third supplier against the decline of the share of the largest supplier is not sufficient to bring about competitive results along these lines; certain other conditions make it possible for the three firms to avoid competitive pricing while shares are changing in that way.

MERGER GUIDELINES ISSUED BY JUSTICE DEPARTMENT, JUNE 14, 1984, AND ACCOMPANYING POLICY STATEMENT S-6 (Bureau of National Affairs, Inc. 1984).

[8] "In general the data suggest that there is no relationship between [noncompetitive levels of] profitability and concentration if [the Herfindahl index] is less than 0.250 or the share of the four largest firms is less than about 80 percent." GEORGE J. STIGLER, THE ORGANIZATION OF INDUSTRY 59 (Richard D. Irwin, Inc. 1968).